

1 UNITED STATES COURT OF APPEALS

2  
3 FOR THE SECOND CIRCUIT

4  
5 August Term, 2002

6  
7 (Argued: August 26, 2002

Decided: January 6, 2004)

8  
9 Docket No. 02-7492

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12  
13 FREEDOM HOLDINGS INC., d/b/a North American Trading Company, and  
14 INTERNATIONAL TOBACCO PARTNERS, LTD., on behalf of themselves and  
15 all others similarly situated,

16  
17 Plaintiffs-Appellants,

18  
19 - v. -

20  
21 ELIOT SPITZER, in his official capacity as Attorney General of  
22 the State of New York, and ARTHUR J. ROTH, in his official  
23 capacity as Commissioner of Taxation and Finance of the State of  
24 New York,

25 Defendants-Appellees.

26  
27 - - - - -  
28 B e f o r e: WINTER, SACK, and SOTOMAYOR, Circuit Judges.

29  
30 Appeal from the dismissal of a complaint challenging  
31 portions of New York "Contraband Statutes," which were passed in  
32 connection with the Master Settlement Agreement between the  
33 country's major tobacco manufacturers and New York State.  
34 Appellants challenge the Contraband Statutes on the grounds that:  
35 (i) they violate the Commerce Clause, U.S. Const. art. I § 8, cl.  
36 3; (ii) they have the effect of establishing an output cartel in  
37 conflict with the Sherman Act; and (iii) New York's selective  
38 nonenforcement as to wholesalers and importers on Native American  
39 reservations violates the Equal Protection Clause. We affirm the

1 dismissal of the Commerce Clause claim. We reverse with respect  
2 to the Sherman Act claim because, on the facts alleged, the  
3 Parker state action doctrine does not immunize the New York  
4 statutes in question from preemption by the Sherman Act. We  
5 remand the selective enforcement claim for further proceedings.

6 Judge Sack concurs in a separate opinion.

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8 Belknap, Webb & Tyler, LLP, New  
9 York, New York, for Plaintiffs-  
10 Appellants.

11  
12 AVI SCHICK, Deputy Counsel to the  
13 Attorney General of the State of  
14 New York (Eliot Spitzer, Attorney  
15 General of the State of New York,  
16 Michael S. Belohlavek, Deputy  
17 Solicitor General of the State of  
18 New York, Daniel Schulze, Assistant  
19 Attorney General of the State of  
20 New York, of counsel), New York,  
21 New York, for Defendants-Appellees.

22  
23 WINTER, Circuit Judge:

24 This appeal involves a challenge to New York legislation  
25 enacted pursuant to the settlement agreement of a host of various  
26 lawsuits brought by most of the states against the major tobacco  
27 manufacturers. Freedom Holdings Inc. and International Tobacco  
28 Partners, Ltd. -- companies that import cigarettes for resale in  
29 New York from foreign manufacturers who are non-parties to the  
30 settlement agreement -- appeal from Judge Hellerstein's dismissal  
31 of their complaint pursuant to Fed. R. Civ. P. 12(b)(6). The  
32 appellees are Eliot Spitzer, Attorney General of the State of New

1 York, and Arthur J. Roth, Commissioner of Taxation and Finance of  
2 the State of New York, both officials with responsibility for  
3 enforcing the laws being challenged, New York Tax Law §§ 480-b,  
4 481, subdiv. 1(c), and 1846 (the "Contraband Statutes").

5 The Contraband Statutes were passed in connection with the  
6 Master Settlement Agreement (the "MSA") executed by the country's  
7 four major tobacco manufacturers and most of the states.

8 Appellants allege -- and at this stage we must assume their  
9 allegations to be true -- that New York's Contraband Statutes  
10 enforce a market-sharing and price-fixing cartel embodied in the  
11 MSA that allows the major tobacco manufacturers to charge supra-  
12 competitive prices, in exchange for sharing their monopoly  
13 profits with the State of New York.

14 Appellants challenge the Contraband Statutes on the grounds  
15 that: (i) they violate the Commerce Clause, U.S. Const. art. I §  
16 8, cl. 3; (ii) they are in conflict with Section 1 of the Sherman  
17 Act, 15 U.S.C. § 1, and therefore preempted; and (iii) New York's  
18 selective nonenforcement as to wholesalers and importers on  
19 Native American reservations violates the Commerce Clause and the  
20 Equal Protection Clause.

21 Appellees moved to dismiss the complaint pursuant to Fed. R.  
22 Civ. P. 12(b)(1) and 12(b)(6). The district court granted the  
23 motion, holding that: (i) the Commerce Clause is not violated  
24 because the Contraband Statutes do not favor local interests over

1 out-of-state interests; (ii) the Contraband Statutes do not  
2 violate the antitrust laws because they are unilateral state  
3 action and are thus not prohibited by the Sherman Act under  
4 Parker v. Brown, 317 U.S. 341 (1943); and (iii) under Washington  
5 v. Confederated Bands and Tribes of the Yakima Indian Nation, 439  
6 U.S. 463 (1979), and New York Ass'n of Convenience Stores v.  
7 Urbach, 92 N.Y.2d 204 (1998), appellants failed to state a valid  
8 equal protection claim.

9 Appellants renew their claims on appeal. We affirm the  
10 dismissal of the Commerce Clause claim. We reverse with respect  
11 to the Sherman Act claim because, based on the complaint's  
12 allegations, the Parker state action immunity doctrine does not  
13 immunize the Contraband Statutes from preemption by the Sherman  
14 Act. In that regard, we reach the same conclusion as did the  
15 Third Circuit in A.D. Bedell Wholesale Co. v. Philip Morris Inc.,  
16 263 F.3d 239 (3d Cir. 2001). We remand the selective enforcement  
17 claim to allow the district court to elaborate on its ruling and  
18 appellants to amend their complaint. We begin with a Table of  
19 Contents.

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1 BACKGROUND

2 a) The Master Settlement Agreement and Related New York  
3 Legislation

4 We begin with a summary of relevant provisions of the MSA  
5 and related New York legislation as alleged in appellants'  
6 complaint. Because this appeal is from a dismissal on the  
7 pleadings, we assume the factual allegations of the complaint to  
8 be true.

9 1. Master Settlement Agreement

10 In 1997, the State, City, and the counties of New York filed  
11 suit against the country's major cigarette manufacturers. See  
12 State v. Philip Morris, Inc., 179 Misc. 2d 435, 686 N.Y.S.2d 564  
13 (N.Y. Sup. Ct. 1998). The action sought to recover damages  
14 related to the costs borne by these various political units of  
15 treating smoking-related illnesses and to impose restrictions on  
16 the cigarette manufacturers' sales, marketing, advertising, and  
17 disclosure practices. Similar actions were brought by 45 other  
18 states. These lawsuits were settled by execution of the MSA in  
19 November 1998. The settlement of the New York lawsuit was  
20 approved by the Supreme Court of New York, New York County, in a  
21 consent decree signed on December 23, 1998. See 179 Misc.2d at  
22 451.

23 The MSA was initially executed by the four dominant (alleged  
24 to account for 98% of cigarette sales at the time) cigarette

1 manufacturers, Philip Morris, Lorillard Tobacco, Brown &  
2 Williamson, and R.J. Reynolds (the "Original Participating  
3 Manufacturers," hereinafter "OPMs"), and by forty-six states  
4 (including New York), the District of Columbia, Puerto Rico,  
5 American Samoa, Guam, the Northern Mariana Islands, and the U.S.  
6 Virgin Islands (the "Settling States"). Thirty-three additional,  
7 and smaller, tobacco companies (the "Subsequent Participating  
8 Manufacturers," hereinafter "SPMs" and, together with the OPMs,  
9 the "Participating Manufacturers," hereinafter "PMs") became  
10 parties to the MSA. It is alleged that, at that time, the PMs  
11 were responsible for 99% of cigarette sales.<sup>1</sup>

12 In general, the MSA imposes numerous restrictions and  
13 requirements in connection with the PMs' sales, marketing,  
14 advertising, lobbying, research, education, and disclosure  
15 practices. See MSA at 15-37. It also requires annual payments  
16 by the OPMs to the Settling States,<sup>2</sup> see MSA at 46-48, and  
17 releases the PMs from future claims by the Settling States, see  
18 MSA at 11-12, 93-101. Any non-participating cigarette  
19 manufacturer ("Non-Participating Manufacturer," hereinafter  
20 "NPM") may become a SPM by signing the MSA and making the  
21 payments that would have been due had it been a signatory as of  
22 the MSA execution date. MSA at 9, 13.

23 The OPMs' overall annual payment obligation is specified in  
24 the MSA.<sup>3</sup> See MSA at 47-48. This obligation is allocated among

1 the OPMs in accordance with their relative market shares. See  
2 MSA at 48. Annual payments to the Settling States are to be  
3 adjusted according to changes in the overall volume of cigarette  
4 sales. See MSA at 48 & Exhibit E. A significant reduction in  
5 sales will therefore lead to a reduction in payments and state  
6 revenue.

7 We turn now to the specific provisions of the MSA that give  
8 rise to the present action. In addition to the link between  
9 overall cigarette sales and payments to the Settling States noted  
10 above, there are provisions for changes in the payments required  
11 of particular companies due to changes in their market share.  
12 One such provision applies to market share losses by any OPM to  
13 other PMs. In general, an OPM losing market share pays less to  
14 the states; an OPM gaining market share pays more. See MSA at  
15 46-47. Future payment obligations of SPMs -- those arising after  
16 the initial payment made upon joining the MSA -- occur only if a  
17 particular manufacturer's market share rises above the greater of  
18 (i) 100% of its 1998 market share, or (ii) 125% of its 1997  
19 market share. Any future payments owed by SPMs are at a rate  
20 approximately equal to that paid by the OPMs. See MSA at 65-68.

21 Another provision governs the reduction of payments where  
22 market share is lost by an OPM to NPMs. This decrease is styled  
23 by the MSA as the "Non-Participating Manufacturer Adjustment"  
24 (the "NPM Adjustment") and reduces required payments if there are

1 any losses of market share experienced by the OPMs as a result of  
2 "disadvantages" arising out of the MSA. MSA at 49-52. Given the  
3 allegations of this complaint, not to mention the name of the NPM  
4 Adjustment, we must assume that one of the contemplated  
5 "disadvantages" is price competition from NPMs. Because the NPM  
6 Adjustment trebles the decrease in payment obligations when an  
7 OPM loses more than 2% due to a "disadvantage," see MSA at 49,  
8 the loss of revenue to the Settling States from an NPM Adjustment  
9 is potentially substantial.<sup>4</sup>

10 Appellants allege that these market-share provisions  
11 constitute an "output cartel" that prevents price competition,  
12 leads to monopoly prices, and encourages Settling State to  
13 protect the cartel in order to preserve the revenue flow to the  
14 States. They claim that the effect of the market-share  
15 provisions is to deter competition among and between OPMs and  
16 SPMs as follows. Increases in a PM's market share would lead to  
17 increased payment obligations that offset or exceed profits from  
18 increased sales. The prospect of such increased obligations  
19 negates the incentive of PMs to compete through price  
20 competition. More than this, appellants allege that this  
21 disincentive induces cigarette manufacturers to follow price  
22 increases by a major manufacturer because there is little to be  
23 gained -- increased market share will be offset or exceeded by  
24 increased payment obligations -- by maintaining a lower price.

1 Finally, they allege that large price and revenue increases have  
2 resulted from the MSA.

3 Of course, the described market-share provisions alone would  
4 reduce competition only until NPMs, who have not agreed to pay  
5 anything to the Settling States, charged less for their  
6 cigarettes and eventually gained market share at the expense of  
7 the PMs. However, the NPM Adjustment substantially reduces the  
8 payment obligations (trebled reductions for losses over 2%) of  
9 the OPMs in the face of such competition, providing incentives to  
10 the Settling States to protect the market share of the OPMs.

## 11 2. New York Escrow Statute

12 Under the MSA, the Settling States do not have to sit idly  
13 by while their MSA tobacco revenue is reduced over time by  
14 competition from NPMs. A Settling State can immunize itself from  
15 downward NPM Adjustments by enacting and "diligently enforc[ing]"  
16 a form "Escrow Statute" -- attached to the MSA, see MSA at 53 &  
17 Exhibit B -- requiring any NPM either: (i) to join the MSA  
18 (becoming a SPM and making future settlement payments accordingly  
19 with respect to any increased market share), or (ii) on a regular  
20 basis to place into a 25-year rolling escrow account funds  
21 alleged to be greater than the amount such manufacturer would pay  
22 were it a SPM under the MSA. All of the Settling States have  
23 enacted Escrow Statutes. See Compl. ¶ 19, at 10.

24 New York enacted its Escrow Statute on November 27, 1999.

1     See N.Y. Pub. Health Law § 1399-nn to 1399-pp (2002). The  
2     Statute provides that any tobacco product manufacturer selling  
3     cigarettes directly or indirectly to consumers within New York  
4     shall either become a PM under the MSA, see N.Y. Pub. Health Law  
5     § 1399-pp(1), or make escrow payments as though it were a SPM,  
6     see N.Y. Pub. Health Law § 1399-pp(2).<sup>5</sup> Specifically, the  
7     statute requires that NPMs who sell cigarettes through a  
8     distributor, retailer, or similar intermediary place a per-pack  
9     fee into an escrow account that may be recovered by the NPM after  
10    twenty years if no such obligation has been incurred. The  
11    statute thus imposes a per-pack fee on NPM-manufactured  
12    cigarettes that adds to the resale price of the product.  
13    Although this fee does not expressly require the product to be  
14    sold at a particular price, the cost to NPMs of complying with  
15    the Escrow Statute is alleged to be higher than the cost to PMs  
16    of complying with the MSA. Compl. ¶ 20, at 10-11.

17         According to the complaint, the Escrow Statute, by  
18    compelling NPMs to make payments -- either by joining the MSA or  
19    by complying with the Escrow Statute -- according to increased  
20    market share, effectively relieves the OPMs of price competition.  
21    See Compl. ¶¶ 17-23, at 9-12. For example, appellants claim that  
22    the payments required (either under the MSA or Escrow Statute) of  
23    SPMs for increased market share are prohibitively high --  
24    amounting to "penalties" -- given the lower operating profit

1 margins of these manufacturers compared to the OPMs. Appellants'  
2 Br. at 13-14. Appellants further allege that escrow payments  
3 required of NPMs under the Escrow Statute are even more  
4 prohibitively expensive because, unlike payments pursuant to the  
5 MSA, they are not tax deductible. Id. at 15. Appellants  
6 describe this elimination of competition as creating an "output  
7 cartel." Id. at 20.

### 8 3. New York's Contraband Statutes

9 Of course, if the Escrow Statute were either fully complied  
10 with or fully enforced, the cartel alleged would be immune to  
11 price competition. However, appellants allege that the market  
12 share of PMs actually declined between 1999 and 2002 from 99% to  
13 approximately 96%. See Note 1, supra. They attribute that  
14 decline to price competition from foreign NPMs that do not comply  
15 with the Escrow Statute. This residual non-compliance is alleged  
16 to result from difficulties in enforcing the Escrow Statute, in  
17 particular against foreign manufacturers, such as those from whom  
18 appellants purchased cigarettes for resale.

19 Effective December 28, 2001, New York passed the Contraband  
20 Statutes in response to this threat. In Governor Pataki's words,  
21 this legislation was needed to "bolster the State's ability to  
22 diligently enforce" the Escrow Statute, and thus to "help protect  
23 the State from further [NPM] adjustments." Appellants' Br. at  
24 18. To be sold lawfully in New York, cigarette packages need to

1 bear a tax stamp affixed by a New York State cigarette tax stamp  
2 agent. The Contraband Statutes add the requirements of the  
3 Escrow Statute to the "gatekeeper" functions already played by  
4 tax stamp agents. The Statutes label as contraband any  
5 cigarettes made by manufacturers that do not comply with the  
6 Escrow Statute. The effect alleged is to impose something  
7 analogous to an in rem liability on the cigarettes themselves,  
8 rendering them subject to seizure and forfeiture, in contrast to  
9 the in personam liability imposed on NPMs by the Escrow Statutes.  
10 Twenty-four of the Settling States have passed Contraband  
11 Statutes. See Appellants' Rule 28(j) letter.

12 It is the Contraband statutes, appearing in Sections 480-b,  
13 481(c) and 1846 of the New York State Tax Law, that are the  
14 object of appellants' challenge. The particulars of the Statutes  
15 are as follows. Section 480-b requires cigarette manufacturers  
16 to certify annually, to the New York State Commissioner of  
17 Taxation and Finance, the Attorney General of the State of New  
18 York, and the cigarette tax stamp agents (according to  
19 appellants, usually wholesalers<sup>6</sup> responsible for affixing New  
20 York State cigarette tax stamps on such manufacturer's  
21 cigarettes), that such manufacturer is either: (a) a PM making  
22 payments under the MSA (i.e. satisfying Section 1399-pp(1) of the  
23 Escrow Statute) or (b) in compliance with the escrow requirements  
24 of Section 1399-pp(2) of the Escrow Statute. N.Y. Tax Law § 480-

1 b(1). Section 480-b also prohibits New York State cigarette tax  
2 stamp agents from affixing tax stamps to cigarettes if the  
3 relevant manufacturer has not provided the required certification  
4 or if the tax stamp agent has been notified by the Commissioner  
5 of Public Health that such manufacturer is in violation of the  
6 Escrow Statute. N.Y. Tax Law § 480-b(2).<sup>7</sup>

7 Section 1846 provides for seizure and forfeiture of any  
8 cigarettes that are unstamped or have been stamped in violation  
9 of Section 480-b. N.Y. Tax Law § 1846(a), (a-1).<sup>8</sup> Section 481,  
10 subdiv. 1(c) authorizes imposition of civil penalties upon any  
11 manufacturer or agent violating Section 480-b. N.Y. Tax Law §  
12 481, subdiv. 1(c).<sup>9</sup>

13 b) The Complaint and Proceedings in the District Court

14 Appellants describe themselves as importers of tobacco  
15 products. Prior to enactment of the Contraband Statutes,  
16 appellants purchased cigarettes from foreign manufacturers and  
17 resold them with the necessary tax stamp to wholesalers and  
18 retailers in New York. However, the foreign manufacturers were  
19 neither PMs under the MSA nor making escrow payments under the  
20 Escrow Statute, and, therefore, were among the group described  
21 above whose continued sales caused the Contraband Statutes to be  
22 enacted. Because of the Contraband Statutes, cigarettes  
23 purchased by appellants from these manufacturers would be without  
24 the certification and tax stamp required for resale and would be

1 subject to seizure and forfeiture.

2 Appellants therefore sought to enjoin enforcement of the  
3 Contraband Statutes on behalf of "all firms throughout the United  
4 States which purchase cigarettes made by manufacturers that do  
5 not make MSA settlement payments and do not make escrow payments  
6 pursuant to the New York State Escrow Statute, and which in turn  
7 resell such cigarettes to the wholesalers that have New York tax  
8 stamp licenses and resell such cigarettes in New York State."<sup>10</sup>  
9 Compl. ¶ 35, at 17. In effect, therefore, appellants are seeking  
10 to sell cigarettes in New York outside the scheme created by the  
11 MSA and enforced by the Contraband Statutes.

12 Appellants' complaint asserts the following claims:

13 (i) The Contraband Statutes interfere with interstate  
14 commerce in order to protect the payments owed to New York State  
15 under the MSA. This constitutes "favoritism, discrimination and  
16 economic protectionism" and is thus a per se violation of the  
17 Commerce Clause. Compl. ¶ 42, at 19.

18 (ii) By implementing the "output cartel" created under the  
19 MSA and the Escrow Statute, the Contraband Statutes conflict with  
20 the Sherman Act, 15 U.S.C. § 1, and are therefore preempted.  
21 Compl. ¶¶ 2, 46, at 3, 19-20.

22 (iii) The selective enforcement of the Contraband Statutes  
23 against firms like appellants but not against wholesalers and  
24 importers on Native American Reservations situated within the

1 State of New York, violates the Commerce and Equal Protection  
2 Clauses. Compl. ¶¶ 42, 49, at 19, 20.

3 After filing their complaint, appellants moved for a  
4 temporary order enjoining appellees from enforcing the Contraband  
5 Statutes. Appellees, in turn, moved to dismiss appellants'  
6 complaint for failure to state a claim under Fed. R. Civ. P.  
7 12(b)(1) and 12(b)(6). After the parties filed memoranda of law  
8 and argued, the district court dismissed the complaint under Rule  
9 12(b)(6). This appeal followed.

#### 10 DISCUSSION

11 We review de novo a district court's dismissal of a  
12 complaint for failure to state a claim under Fed. R. Civ. P.  
13 12(b)(6). Leeds v. Meltz, 85 F.3d 51, 53 (2d Cir. 1996). We  
14 accept as true the material facts alleged in the complaint and  
15 draw all reasonable inferences in plaintiffs' favor. Hernandez  
16 v. Coughlin, 18 F.3d 133, 136 (2d Cir. 1994). A complaint cannot  
17 be dismissed for failure to state a claim "unless it appears  
18 beyond doubt that the plaintiff can prove no set of facts in  
19 support of his claim which would entitle him to relief." Conley  
20 v. Gibson, 355 U.S. 41, 45-46 (1957).

#### 21 a) Dormant Commerce Clause Claim

22 The Commerce Clause provides that "Congress shall have  
23 Power . . . [t]o regulate Commerce with foreign Nations and among  
24 the several States. . . ." U.S. Const. art. I, § 8, cl. 3.

1 Under the so-called "dormant" Commerce Clause doctrine, a state's  
2 power to take actions impacting interstate commerce is limited.  
3 See Hughes v. Oklahoma, 441 U.S. 322, 326 (1979); Automated  
4 Salvage Transp., Inc. v. Wheelabrator Env'tl. Sys., Inc., 155 F.3d  
5 59, 74 (2d Cir. 1998).

6 A state statute may violate the dormant Commerce Clause in  
7 several ways. First, a statute that clearly discriminates  
8 against interstate commerce in favor of intrastate commerce is  
9 "virtually invalid per se," Nat'l Elec. Mfrs. Ass'n v. Sorrell,  
10 272 F.3d 104, 108 (2d Cir. 2001); see also Wyoming v. Oklahoma,  
11 502 U.S. 437, 454-55 (1992) (noting that when a statute clearly  
12 discriminates against interstate commerce, it will be struck down  
13 as per se invalid), and can survive only if the discrimination is  
14 "demonstrably justified by a valid factor unrelated to economic  
15 protectionism," id. at 454. Second, if the statute does not  
16 discriminate against interstate commerce, it will nevertheless be  
17 invalidated under the "Pike balancing test" if it "imposes a  
18 burden on interstate commerce incommensurate with the local  
19 benefits secured." Nat'l Elec. Mfrs., 272 F.3d at 108 (citing  
20 Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970)). Third, a  
21 statute will be invalid per se if it has the practical effect of  
22 "extraterritorial" control of commerce occurring entirely outside  
23 the boundaries of the state in question. See Healy v. The Beer  
24 Inst., 491 U.S. 324, 336 (1989).<sup>11</sup>

1 Even assuming that appellants raised each of these theories  
2 in the district court and on appeal and that they are properly  
3 before us,<sup>12</sup> none constitutes a valid claim under any version of  
4 the dormant Commerce Clause doctrine.

5 1. Analysis Under the "Clear Discrimination" Standard and  
6 "Pike Balancing Test"

7 A state statute violates the "clear discrimination" standard  
8 when it constitutes "differential treatment of in-state and out-  
9 of-state economic interests that benefits the former and burdens  
10 the latter." Or. Waste Sys., Inc. v. Dep't of Env'tl. Quality,  
11 511 U.S. 93, 99 (1994); see also West Lynn Creamery, Inc. v.  
12 Healy, 512 U.S. 186, 192 (1994) ("[T]he [dormant] Commerce Clause  
13 prohibits economic protectionism -- that is, regulatory measures  
14 designed to benefit in-state economic interests by burdening out-  
15 of-state competitors." (internal citation and quotation marks  
16 omitted)).

17 In contrast, under the Pike balancing test, appellants must  
18 show that a statute enacted for a legitimate public purpose,  
19 although apparently evenhanded, actually imposes "'burdens on  
20 interstate commerce that exceed the burdens on intrastate  
21 commerce,'" Automated Salvage Transp., 155 F.3d at 75 (quoting  
22 Gary D. Peake Excavating Inc. v. Town Bd. of Hancock, 93 F.3d 68,  
23 75 (2d Cir. 1996)), and that those excess burdens on interstate  
24 commerce are "clearly excessive in relation to the putative local

benefits," Pike, 397 U.S. at 142. "[T]he statute, at a minimum, must impose a burden on interstate commerce that is qualitatively or quantitatively different from that imposed on intrastate commerce." Nat'l Elec. Mfrs., 272 F.3d at 109. Under the Pike test, "if no such unequal burden be shown, a reviewing court need not proceed further." Id.

The bottom line is therefore that, under either the "clear discrimination" or the "Pike" forms of analysis, "the minimum showing required . . . is that [the state statute] have a disparate impact on interstate commerce." Automated Salvage Trans., 155 F.3d at 75. Because the Contraband Statutes have no such disparate impact, either facially or in incidental effect, appellants' claim fails.

Appellants cannot and do not identify any in-state commercial interest that is favored, directly or indirectly, by the Contraband Statutes at the expense of out-of-state competitors. Appellants concede that "virtually all cigarettes sold at retail in New York are purchased out of state." Appellants' Reply Br. at 6. Moreover, the Contraband Statutes apply equally to the products of in-state and out-of-state manufacturers, and to products sold by and to in-state and out-of-state wholesalers, tax agents, and importers. Any "'incidental' burdens," Minn. v. Clover Leaf Creamery Co., 449 U.S. 456, 471 (1981), on products originating out-of-state --

1 i.e., the so-called “[e]mbargoing” of the cigarettes of NPMs  
2 purchased by appellants, Appellants’ Br. at 5 -- is a result of  
3 their failure to comply with the Escrow and Contraband Statutes,  
4 a burden that is no greater for out-of-state economic interests  
5 than for in-state ones.

6 To remedy this gap in their argument, appellants offer  
7 several novel theories. First, they propose that New York State  
8 itself is the “local” interest benefitted by the Contraband  
9 Statutes and that the goal of ensuring New York’s receipt of the  
10 maximum revenue under the MSA constitutes a facially  
11 protectionist objective. However, there is simply no precedent  
12 to support the proposition that a state’s generation of revenues  
13 at the expense of in-state and out-of-state economic interests  
14 alike is, without more, invalidly protectionist for Commerce  
15 Clause purposes. Nor are there grounds to create such a  
16 precedent.

17 For dormant Commerce Clause purposes, the relevant “economic  
18 interests,” both in-state and out-of-state, are parties using the  
19 stream of commerce, not those of the state itself. See West Lynn  
20 Creamery, 512 U.S. at 202 (describing economic interests relevant  
21 to differential burden analysis as “any part of the stream of  
22 commerce -- from wholesaler to retailer to consumer”); id. at 192  
23 (stating that the dormant Commerce Clause prohibits state  
24 regulations that “benefit in-state economic interests by

1   burdening out-of-state competitors" (emphasis added)). Were the  
2   Contraband Statutes directed solely at out-of-state economic  
3   interests, see Guy v. Baltimore, 100 U.S. 434, 443 (1880)  
4   (invalidating a Maryland wharfage fee regulation that imposed  
5   fees only on cargo not produced in Maryland), or in-state  
6   economic interests exempted from the Contraband Statutes'  
7   requirements, see Bacchus Imports, Ltd. v. Dias, 468 U.S. 263,  
8   273 (1984) (invalidating a Hawaii statute that favored local  
9   producers by granting a tax exemption on certain liquors produced  
10   in Hawaii), or the MSA revenues used to subsidize local economic  
11   interests in competition with out-of-state economic interests  
12   subjected to the Contraband Statutes, see West Lynn Creamery, 512  
13   U.S. at 194-95 (invalidating a Massachusetts statutory scheme  
14   that imposed a uniform tax on milk sales and then used the  
15   proceeds of that tax to subsidize Massachusetts milk producers),  
16   appellants might be able to state a valid claim. However, the  
17   Contraband Statutes do none of these things.

18       Second, appellants propose that the PMs -- although located  
19   out-of-state -- are a "local" interest benefitted by the  
20   Contraband Statutes, and that the goal of protecting their New  
21   York market share constitutes a facially protectionist objective.  
22   Appellants' Br. at 30. Appellants rely upon the following  
23   passage -- that does not say what they claim -- from the Supreme  
24   Court's opinion in Bacchus Imports to support this odd

1 contention:

2 The State does not seriously defend the Hawaii Supreme  
3 Court's conclusion that because there was no  
4 discrimination between in-state and out-of-state  
5 taxpayers there was no Commerce Clause violation. Our  
6 cases make clear that discrimination between in-state  
7 and out-of-state goods is as offensive to the Commerce  
8 Clause as discrimination between in-state and out-of-  
9 state taxpayers.

10 Bacchus Imports, 468 U.S. at 268 n.8 (emphasis in original). In  
11 fact, the quoted passage stands only for the proposition that  
12 disparate treatment of in-state and out-of-state manufacturers  
13 (i.e., "goods") is just as much a violation of the Commerce  
14 Clause as disparate treatment of in-state and out-of-state  
15 consumers (i.e., "taxpayers"). To be prohibited, a statute still  
16 must favor an in-state commercial interest over a corresponding  
17 out-of-state commercial interest, an element absent in the  
18 present matter. See Or. Waste Sys., Inc., 511 U.S. at 100  
19 (invalidating Oregon statute that favored shippers of "Oregon  
20 waste" over shippers of waste from "other States"); West Lynn  
21 Creamery, 512 U.S. at 192 (requiring benefit to "in-state  
22 economic interests" and burden to "out-of-state" interests);  
23 United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.,  
24 261 F.3d 245, 262 (2d Cir. 2001) (upholding statute where burden  
25 imposed "does not fall more heavily on out-of-state concerns than  
26 on local ones").

27 Thus, the Contraband Statutes are not "clearly

1 discriminatory," and, under the Pike balancing test, do not  
2 impose "unequal burdens" on interstate and intrastate commerce.  
3 As such, we "need not proceed further." Nat'l Elec. Mfrs., 272  
4 F.3d at 109.

## 5 2. Extraterritoriality Analysis

6 In their reply brief, appellants rely upon a line of Supreme  
7 Court price-regulation cases to argue that the Contraband  
8 Statutes violate the dormant Commerce Clause by regulating  
9 commerce occurring wholly outside the borders of New York. See  
10 Appellants' Rep. Br. at 7 (citing Baldwin v. G.A.F. Seelig, Inc.,  
11 294 U.S. 511, 521 (1935); Healy, 491 U.S. at 336; Brown-Forman  
12 Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 583-84  
13 (1986)). Even assuming that appellants have properly preserved  
14 this argument below and raised it on appeal, see Note 12, supra,  
15 it is without merit.

16 As noted, a state statute will be invalid per se under the  
17 Commerce Clause if it has the practical effect of controlling  
18 commerce occurring wholly outside that State's borders. Healy,  
19 491 U.S. at 332. In Healy, the Supreme Court described in detail  
20 how to assess a statute's constitutionality under the  
21 "extraterritoriality" branch of dormant Commerce Clause analysis  
22 as follows:

23 First, the Commerce Clause . . . precludes the  
24 application of a state statute to commerce that takes

1 place wholly outside of the State's borders, whether or  
2 not the commerce has effects within the State, and,  
3 specifically, a State may not adopt legislation that  
4 has the practical effect of establishing a scale of  
5 prices for use in other states. Second, a statute that  
6 directly controls commerce occurring wholly outside the  
7 boundaries of a State exceeds the inherent limits of  
8 the enacting State's authority and is invalid  
9 regardless of whether the statute's extraterritorial  
10 reach was intended by the legislature. The critical  
11 inquiry is whether the practical effect of the  
12 regulation is to control conduct beyond the boundaries  
13 of the State. Third, the practical effect of the  
14 statute must be evaluated not only by considering the  
15 consequences of the statute itself, but also by  
16 considering how the challenged statute may interact  
17 with the legitimate regulatory regimes of other States  
18 and what effect would arise if not one, but many or  
19 every, State adopted similar legislation. Generally  
20 speaking, the Commerce Clause protects against  
21 inconsistent legislation arising from the projection of  
22 one state regulatory regime into the jurisdiction of  
23 another State.

24 Id. at 336-37 (internal quotation marks, citations and footnotes  
25 omitted).<sup>13</sup>

26 Appellants claim that the "artificially high prices"  
27 fostered by the Contraband Statutes "inflate[]" the prices  
28 charged by cigarette manufacturers to purchasers in sales  
29 transactions that occur wholly outside the State of New York.  
30 Appellants' Reply Br. at 6. Thus, appellants argue, the  
31 Contraband Statutes are regulating out-of-state commerce in the  
32 sense that, in an out-of-state transaction, "[a] purchaser of  
33 . . . product bought for resale at retail in New York either pays  
34 the price set by the Cartel or forfeits the right to ship  
35 cigarettes for sale at retail into the State of New York." Id.

1 Appellants argue that this extraterritorial effect renders the  
2 Contraband Statutes per se invalid under the dormant Commerce  
3 Clause. Id. at 7.

4 Even assuming for present purposes that appellants'  
5 characterization of the Contraband Statutes' effect is accurate,  
6 the "practical effect" of the Contraband Statutes on  
7 extraterritorial commerce does not rise to the level of a  
8 constitutionally impermissible act. The effect does not  
9 constitute the "regulati[on of] commerce," Healy, 491 U.S. at  
10 332, "control[ of] commerce," id. at 336, "projection of one  
11 state regulatory regime into the jurisdiction of another State,"  
12 id. at 337, or "application of a state statute to  
13 [extraterritorial] commerce," id. at 336, necessary to render a  
14 state statute invalid.

15 The extraterritorial effect described by appellants amounts  
16 to no more than the upstream pricing impact of a state  
17 regulation. Because cigarettes sold at retail must have been  
18 produced only by manufacturers in certified compliance with New  
19 York's Escrow Statute, importers such as appellants must buy more  
20 expensive, "certified" cigarettes (in their out-of-state  
21 transactions) if they wish to sell to New York retailers.  
22 However, a similar pricing impact might result from any state  
23 regulation of a product, and "[t]he mere fact that state action  
24 may have repercussions beyond state lines is of no judicial

1 significance so long as the action is not within that domain  
2 which the Constitution forbids." Osborn v. Ozlin, 310 U.S. 53,  
3 62 (1940); see also Healy, 491 U.S. at 345 (Scalia, J.,  
4 concurring in part and concurring in the judgment) (noting that  
5 "innumerable valid state laws affect pricing decisions in other  
6 States," and cautioning against allowing Commerce Clause  
7 jurisprudence to "degenerate into disputes over degree of  
8 economic effect"). While the out-of-state wholesale prices of  
9 cigarettes may be affected by the Contraband Statutes, therefore,  
10 out-of-state actors such as appellants remain free to conduct  
11 commerce on their own terms, without either scrutiny or control  
12 by New York State.

13 By contrast, in the Supreme Court cases relied upon by  
14 appellants, Seelig,<sup>14</sup> Brown-Forman,<sup>15</sup> and Healy,<sup>16</sup> the Court struck  
15 down state statutes that went a step further, controlling in-  
16 state and out-of-state pricing of goods going into the state.  
17 These statutes did so by making specific reference to the terms  
18 of such pricing -- terms which burdened out-of-state actors more  
19 than in-state actors -- and attaching in-state consequences where  
20 the pricing terms violated the statutes. Unlike the statutes at  
21 issue in Seelig, Brown-Forman, and Healy, the Contraband Statutes  
22 impose no such out-of-state burden and therefore cannot be said  
23 either to regulate prices or otherwise to control the terms of  
24 out-of-state transactions.

1 Finally, appellants have not alleged that the Contraband  
2 Statutes are inconsistent with the legitimate regulatory regimes  
3 of other states, see Healy, 491 U.S. at 336-37, that the  
4 Contraband Statutes force out-of-state merchants to seek New York  
5 regulatory approval before undertaking an out-of-state  
6 transaction, see id. at 337, or that any sort of interstate  
7 regulatory gridlock would occur if "many or every" state adopted  
8 similar legislation, see id. at 336, 339-40. In short, none of  
9 the indicia of an impermissible extraterritorial regulation are  
10 present.

11 b) Sherman Act Claim

12 Appellants' complaint alleges that the Contraband Statutes  
13 are "an implementation illegal per se under § 1 of the Sherman  
14 Act of an output cartel, [are] in direct conflict with that law  
15 and [are], accordingly, preempted by that Act." Compl. ¶ 2, at  
16 3. The district court dismissed this claim on the sole ground  
17 that the Contraband Statutes are "immune from antitrust  
18 prosecution, because they represent a unilateral state action,  
19 not prohibited under the Sherman Act." Freedom Holdings, Inc. v.  
20 Spitzer, No. 02 CIV 2929, tr. at 45 (S.D.N.Y. May 14, 2002) (oral  
21 findings and conclusions) (citing Parker, 317 U.S. 341). The  
22 court further noted that, in its view, "New York was not seeking  
23 to create any benefit to the cigarette manufacturing companies .  
24 . . . New York was dealing, as [were] the other states, in a

1 very important local health interest. It enacted legislation  
2 that it considered appropriate to remedy these interests. That's  
3 the very thing that Parker v. Brown immunizes." Id. at 49.

#### 4 1. Preemption Analysis

5 The Sherman Act embodies a federal policy prohibiting  
6 anticompetitive conduct by private firms. Under the Supremacy  
7 Clause, of course, the power of states to adopt policies that  
8 conflict with federal law is limited. In the context of the  
9 Sherman Act, the use of the Supremacy Clause to preempt a state  
10 law that limits competition among private firms is complicated by  
11 the fact that state police powers and regulatory authority have  
12 traditionally been thought to extend legitimately to a range of  
13 anticompetitive schemes. No one seriously argues, therefore,  
14 that the Sherman Act was intended to preempt all such regulation.  
15 On the other hand, "[t]he national policy in favor of competition  
16 cannot be thwarted by casting . . . a gauzy cloak of state  
17 involvement over what is essentially a private price-fixing  
18 arrangement." Cal. Reg'l Liquor Dealers Ass'n v. Midcal  
19 Aluminum, Inc., 445 U.S. 97, 106 (1980). Viewing state  
20 regulation on a spectrum, at one end is state utility regulation,  
21 which in its usual form combines a state-protected monopoly with  
22 rate regulation and is not subject to preemption. See Bedell,  
23 263 F.3d at 255. At the other end is a state law that purports  
24 to legalize price-fixing by private firms for no stated purpose

1 other than protecting the private price-fixers from competition.  
2 Such a law is subject to preemption. See Parker, 317 U.S. at  
3 351. Whether state statutory schemes on this spectrum are  
4 preempted depends on both the state policy goals and the  
5 regulatory means applied. We defer discussion of the legal  
6 ramifications of particular goals and means to part (b)(3) of  
7 this section of our opinion.

8 Whether a state statute that restrains competition among  
9 private firms is preempted by the Sherman Act is determined by a  
10 two-step analysis. The plaintiff must first show that the scheme  
11 of market control created by the statute would constitute a per  
12 se violation of the Sherman Act if brought about by an agreement  
13 among private parties. A statute will be preempted by the  
14 Sherman Act only if it "mandates or authorizes conduct that  
15 necessarily constitutes a violation of the antitrust laws in all  
16 cases, or if it places irresistible pressure on a private party  
17 to violate the antitrust laws in order to comply with the  
18 statute." Fisher v. Berkeley, 475 U.S. 260, 265 (1986) (quoting  
19 Rice v. Norman Williams Co., 458 U.S. 654, 661 (1982));  
20 Battipaglia v. N.Y. State Liquor Auth., 745 F.2d 166, 174 (2d  
21 Cir. 1984) (quoting Rice, 458 U.S. at 661)); see also 324 Liquor  
22 Corp. v. Duffy, 479 U.S. 335, 341 (1987) (describing the  
23 "threshold question" as whether the state statute is inconsistent  
24 with the antitrust laws); Midcal, 445 U.S. at 102 (1980) (same).

1 For a statute to be preempted, the conduct contemplated by the  
2 statute must be "in all cases a per se violation" of the federal  
3 antitrust laws. Battipaglia, 745 F.2d at 174 (quoting Rice, 458  
4 U.S. at 661).

5 Even if a per se violation is shown, the alleged  
6 anticompetitive scheme may still be immunized under the Parker  
7 state action doctrine only where it regulates commerce in  
8 furtherance of legitimate state policy goals and limits  
9 unnecessary anticompetitive effects. A statute that permits or  
10 compels private parties to engage in per se violations of the  
11 federal antitrust laws will be saved from preemption if: (i) the  
12 restraint in question is "clearly articulated and affirmatively  
13 expressed as state policy," and (ii) the policy is "actively  
14 supervised" by the state itself. Midcal, 445 U.S. at 105  
15 (quoting City of Lafayette v. La. Power & Light Co., 435 U.S.  
16 389, 410 (1978)).

17 We address these analytic steps in turn.

## 18 2. Per Se Violation

19 As noted, the first question is whether the scheme alleged  
20 to have been created by the Contraband Statutes would constitute  
21 a per se violation of federal antitrust law if brought about by  
22 an agreement among private parties.

### 23 (i) Unilateral Act of State

1 Appellees argue that appellants cannot meet this test  
2 because a per se violation requires, in the language of the  
3 Sherman Act itself, a private "contract, combination, or  
4 conspiracy" to restrain trade and that what is challenged here is  
5 a "unilateral act" of government rather than a "contract,  
6 combination, or conspiracy." Appellees' Br. at 39. This  
7 argument ignores both applicable Supreme Court caselaw and the  
8 relationship of the Contraband Statutes to the MSA as alleged in  
9 the complaint.

10 First, the unilateral act of a state government protecting  
11 private parties from competition can be preempted by the Sherman  
12 Act. Where the anticompetitive effects of a state statute  
13 obviate the need for private parties to act on their own to  
14 create an anticompetitive scheme, the statute may be attacked as  
15 a "hybrid" restraint on trade. In 324 Liquor, the Supreme Court  
16 held:

17 Where "private actors are granted a degree of private  
18 regulatory power [by a state] the regulatory scheme may  
19 be attacked under § 1" as a "hybrid" restraint. . . .  
20 [T]he federal antitrust laws pre-empt state laws  
21 authorizing or compelling private parties to engage in  
22 anticompetitive behavior.

23 324 Liquor, 479 U.S. at 345-46 n.8 (some internal quotation marks  
24 and ellipses omitted) (quoting Fisher v. Berkeley, 475 U.S. 260,  
25 268 (1986) (quoting Rice v. Norman Williams Co., 458 U.S. 654,  
26 666, n.1 (1982) (Stevens, J., concurring in the judgment))). In

1 rejecting the position taken by appellees, namely that a private  
2 "contract, combination, or conspiracy" must be shown to support a  
3 Sherman Act preemption claim,<sup>17</sup> the Court stated that the federal  
4 antitrust laws may preempt state laws that authorize or compel  
5 private parties to engage in anticompetitive behavior. See id.

6 Second, 324 Liquor itself invalidated a statute that was far  
7 more "unilateral" than the scheme alleged here. 324 Liquor  
8 involved a New York law that required liquor retailers to charge  
9 112% of wholesalers' posted bottle prices where that posting of  
10 prices was also required by New York law. 479 U.S. at 337-39.  
11 The only private acts involved were the individual determinations  
12 of each wholesaler as to what bottle price to post. Id. at 337-  
13 40.

14 By sharp contrast, the Contraband Statutes allegedly enforce  
15 an express market-sharing agreement among private tobacco  
16 manufacturers, the MSA. As alleged in the complaint, the  
17 Contraband Statutes are the result of the incentives created by  
18 the MSA for the States, here New York, to pass legislation that  
19 would prevent NPM Adjustments caused by price competition from  
20 diminishing revenue to the State.<sup>18</sup> The MSA was an agreement  
21 involving the State of New York, but it also was by any  
22 definition a "contract" that the four major tobacco manufacturers  
23 jointly negotiated among themselves (and for which they  
24 unsuccessfully sought an antitrust exemption from the Congress<sup>19</sup>)

1 and with the states, and that other smaller manufacturers  
2 subsequently joined. The parties to the MSA are alleged in the  
3 complaint to constitute horizontal competitors originally  
4 controlling 99% of the market. Even if a "contract" among  
5 private parties is required in the first step of preemption  
6 analysis, therefore, it exists in the present matter.<sup>20</sup>

7 (ii) The Allegations of the Complaint

8 We turn then to the question whether the behavior alleged to  
9 be authorized or compelled by the Contraband Statutes (i.e.,  
10 enforcement of the alleged output cartel) would be a per se  
11 Sherman Act violation if done by private agreement. See  
12 generally 1 Philip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶  
13 217b2, at 306-07 (2d ed. 2000).

14 Horizontal agreements among competing sellers to fix prices  
15 or restrict output are, absent more, per se violations of Section  
16 1 of the Sherman Act. See Nat'l Collegiate Athletic Ass'n v. Bd.  
17 of Regents of the Univ. of Okla., 468 U.S. 85, 100 (1984)  
18 ("Horizontal price fixing and output limitation are ordinarily  
19 condemned as a matter of law under an 'illegal per se' approach  
20 because the probability that these practices are anticompetitive  
21 is so high; a per se rule is applied when 'the practice facially  
22 appears to be one that would always or almost always tend to  
23 restrict competition and decrease output.'" (quoting Broad.  
24 Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 19-20

1 (1979))) ; Bedell, 263 F.3d at 247 ("An agreement which has the  
2 purpose and effect of reducing output is illegal under § 1 of the  
3 Sherman Act."); see also Gen. Leaseways, Inc. v. Nat'l Truck  
4 Leasing Ass'n, 744 F.2d 588, 594-95 (7th Cir. 1984) ("[W]ith  
5 exceptions not relevant here, raising price, reducing output, and  
6 dividing markets have the same anticompetitive effects."), quoted  
7 in Cal. Dental Ass'n v. FTC, 526 U.S. 756, 777 (1999); United  
8 States v. Andreas, 39 F. Supp. 2d 1048, 1060 (N.D. Ill. 1998)  
9 ("Direct price agreements and sales volume are two sides to the  
10 same price-fixing coin").

11 Appellants have alleged in detail that the MSA/Contraband  
12 Statutes scheme involves both market division and price-fixing.  
13 As alleged, the MSA was agreed to by horizontal competitors who  
14 originally controlled 99% of the market for cigarettes and  
15 created substantial disincentives for any PM to attempt to  
16 increase its market share through price competition. These  
17 disincentives are found in the MSA's various provisions requiring  
18 that increased payment obligations accompany increased market  
19 share. Because market-share increases among manufacturers are  
20 substantially "penalized," see note 5, supra, Compl. ¶ 17, at 9,  
21 appellants allege that the OPMs, as market share leaders, have  
22 the discretion to increase prices -- at least until higher prices  
23 would reduce profits -- assured that competitors will follow  
24 their price lead so as to avoid picking up a new market share,

1 profits from which will be offset by required payments to the  
2 Settling States. As the Third Circuit observed in Bedell:

3 [I]t is clear the [MSA] empowers the tobacco companies  
4 to make anticompetitive decisions with no regulatory  
5 oversight by the States. Specifically, the defendants  
6 are free to fix and raise prices, allegedly without  
7 fear of competition.

8 Bedell, 263 F.3d at 260; see also id. at 246 (citing plaintiffs'  
9 allegations that the four majors could have funded the settlement  
10 agreement with a \$0.19 increase in price, but that the majors  
11 immediately raised prices by \$0.45 per pack, and subsequently by  
12 another \$0.31 per pack). The scheme as alleged also involves  
13 market division and price-fixing enforced against NPMs by  
14 wholesalers refusing to deal with them because of the provisions  
15 of the Contraband Statutes. In short, plaintiffs allege that the  
16 combination of the MSA, the Escrow Statutes, and the Contraband  
17 Statutes, allows OPMs to set supracompetitive prices that  
18 effectively cause other manufacturers either to charge similar  
19 prices or to cease selling. Compl. ¶¶ 2, 13, 17, 20, at 2-11.  
20 NPMs are forced to charge these prices to cover the costs imposed  
21 by the Escrow and Contraband Statutes or go out of business in  
22 New York.

23 The alleged arrangement, even without the protection of the  
24 Contraband Statutes as enforced by wholesalers, would be a per se  
25 violation because it is a naked restraint on competition, albeit  
26 one subject to erosion by NPMs. See 11 Herbert Hovenkamp,

1 Antitrust Law, ¶ 1910, at 252-65 (1998) (per se illegality for  
2 "naked" restraints.) With the Contraband Statutes in force, the  
3 scheme as alleged threatens to become a permanent, nationwide  
4 cartel, see note 13, supra.

5 Had the executives of the major tobacco companies entered  
6 into such an arrangement without the involvement of the States  
7 and their attorneys general, those executives would long ago have  
8 had depressing conversations with their attorneys about the  
9 United States Sentencing Guidelines. See U.S.S.G. § 2R1.1  
10 (Antitrust Offenses). We therefore hold that appellants have  
11 sufficiently alleged a per se violation of the Sherman Act.

### 12 3. State Action Immunity

13 We now turn to the question of whether the statute is saved  
14 from preemption under Parker v. Brown. As noted, Parker  
15 preserves the ability of states to promulgate anticompetitive  
16 regulations in furtherance of legitimate state policy goals. See  
17 Parker, 317 U.S. at 350-51 (declining to attribute to Congress's  
18 enactment of the Sherman Act "an unexpressed purpose to nullify a  
19 state's control over its officers and agents"); 1 Areeda &  
20 Hovenkamp, supra, ¶ 217d, at 316-17. A common example is state  
21 protection and regulation of monopolies that provide services  
22 such as electric power. See Bedell, 263 F.3d at 255. However,  
23 as Parker noted, a state cannot simply "give immunity to those  
24 who violate the Sherman Act by authorizing them to violate it, or

1 by declaring that their action is lawful." Parker, 317 U.S. at  
2 351. Rather, as Midcal made explicit, the state must substitute  
3 its own policy objectives and regulatory oversight for the  
4 federal antitrust policy and enforcement mechanisms displaced by  
5 the state legislation. That is, if a state statute mandates or  
6 authorizes per se violations of the antitrust laws, it will be  
7 saved from preemption only if (i) the restraint in question is  
8 "clearly articulated and affirmatively expressed as state  
9 policy," and (ii) the policy is "actively supervised" by the  
10 State itself. Midcal, 445 U.S. at 105 (quoting City of  
11 Lafayette, 435 U.S. at 410).

12 (i) Clear Articulation and Affirmative Expression

13 We turn then to the first prong of the Midcal analysis,  
14 whether the anticompetitive restraint alleged -- the output  
15 cartel -- has been "clearly articulated and affirmatively  
16 expressed as state policy." We are somewhat disadvantaged in  
17 discussing this question because the district court never  
18 addressed it and the parties' briefs have not joined issue on it.  
19 Appellants found no need to dwell on the issue because the second  
20 Midcal requirement -- state oversight of the pricing conduct of  
21 the tobacco firms protected by the Contraband Statutes -- is  
22 obviously not met. Appellees in turn have been content to rest  
23 their case essentially on the "unilateral act" argument rejected  
24 above and on conclusory references to claimed health care

1 benefits resulting from the MSA.

2 (A) Express Adoption of an Anticompetitive Scheme

3 One purpose of the first Midcal prong is to ensure that  
4 state action immunity is afforded only to actions taken by the  
5 state. Most assuredly, agreement to the MSA by the New York  
6 Attorney General,<sup>21</sup> approval of it by a New York court, and  
7 passage of the Contraband Statutes were express acts of the State  
8 of New York. This purpose of the first Midcal prong is therefore  
9 satisfied. See Cine 42d St. Theater Corp. v. Nederlander Org.,  
10 790 F.2d 1032, 1042 (2d Cir. 1986).

11 (B) State Policy Goals

12 \_\_\_\_\_However, there is an ancillary purpose of this Midcal prong,  
13 which in this case is to reveal the State's purposes in agreeing  
14 to, and enforcing, the MSA's market-share provisions. These  
15 purposes must be known to ensure that the State's policy goals  
16 are sufficient to qualify for the Parker immunity -- simply  
17 protecting private parties from competition is not a sufficient  
18 goal, see Parker, 317 U.S. at 351-52. Of course, if the purposes  
19 are not of the kind that would trigger Parker analysis, we  
20 generally would deny the immunity on Parker grounds rather than  
21 on a failure to satisfy the first Midcal prong. Indeed, it is  
22 doubtful that a federal court would upset a state statute solely  
23 because it failed to meet the explanatory aspect of the first

1 Midcal prong if it passed muster in all other respects.  
2 Nevertheless, that prong does implicate the purposes of the  
3 State, and we accordingly discuss the enunciated goals of the  
4 Contraband Statutes and MSA here.

5 On the record before us, the statement closest to  
6 articulating the State's interest is Governor Pataki's memorandum  
7 urging passage of the Contraband Statutes, which stated:

8 The . . . Master Settlement Agreement (MSA) requires  
9 downward adjustment in payments to states if it is  
10 determined that the MSA caused the participating  
11 manufacturers to lose aggregate market share to  
12 nonparticipating manufacturers (NPM's). States can  
13 protect themselves from NPM adjustments by enacting [an  
14 Escrow Statute], and "diligently enforcing" that law.  
15 Immediate enactment of the [Contraband Statutes] would  
16 substantially bolster the State's ability to diligently  
17 enforce the [Escrow Statute] and help protect the State  
18 from future [NPM] adjustments . . . .

19 Appellants' Br. at 18 (quoting Governor Pataki Memorandum of Oct.  
20 29, 2001). While this statement admits the State's interest in  
21 the revenue from cigarette sales, it falls short of expressly  
22 stating why the market-share provisions are needed to effectuate  
23 state policy goals.

24 The Escrow Statute contains a "Findings and purpose"  
25 section, set out in full in the margin,<sup>22</sup> that notes: (i) the  
26 health dangers of cigarettes, (ii) the resultant health care  
27 costs to the State, (iii) the OPMs' obligation to pay substantial  
28 sums to the State, (iv) the fact that these payments are "tied in

1 part to their volume of sales," and (v) the state's policy of  
2 preventing NPMs from using their cost advantage to reap greater  
3 profits while the State bears the resultant health care costs.  
4 However, this "Findings and purpose" section articulates no more  
5 than the conceded health concerns over cigarettes, a settlement  
6 that includes a levy on every cigarette sold by the OPMs, and a  
7 need to force NPMs to pay a similar amount.

8 Also, appellees assert in their brief, but without  
9 elaboration, that the MSA's market-share provisions are designed  
10 "to ensure that MSA payments per cigarette remain essentially  
11 constant regardless of whether sales increase or decrease,"  
12 Appellees' Br. at 11, and that the payment obligations of the MSA  
13 do nothing other than "protect the State from having to bear the  
14 costs of an inherently deadly product," *id.* at 44.

15 Appellee's arguments therefore equate the MSA's market-share  
16 provisions with a flat tax levied on every cigarette sold.  
17 Indeed, a flat levy would accomplish the purposes set out in the  
18 Escrow Statute and appellees' brief, without anticompetitive  
19 effects and without creating any conflict with the Sherman Act.<sup>23</sup>  
20 A flat levy on every cigarette sold would not prevent price  
21 competition among cigarette manufacturers whereas the scheme  
22 alleged by appellants involves: (i) adjustments based on a  
23 particular manufacturer's market share as well as total volume,  
24 (ii) trebled decreases in payments under the NPM Adjustment,

1 (iii) immunity from NPM Adjustments for Settling States that pass  
2 Escrow Statutes and "diligently enforce" them through Contraband  
3 Statutes, (iv) alleged disincentives for SPMs to increase market  
4 share, and (v) differential tax effects of the Escrow and  
5 Contraband Statutes on NPMs, all of which are alleged to  
6 constitute an output cartel in which the State shares profits.  
7 We are not second-guessing the State's choice of means to a  
8 policy goal. We are simply noting the fact that the State denies  
9 any anti-competitive effect and offers no explanation for the  
10 anti-competitive scheme that is alleged and challenged by  
11 appellants.

12 We note in that regard that it is questionable whether  
13 Parker immunity extends to a cartel arrangement supported by a  
14 state solely to allow the state to share the monopoly profits as  
15 state revenue, perhaps implied as the goal of the Contraband  
16 Statutes in Governor Pataki's statement quoted above. States may  
17 not shield private parties from competition solely to benefit  
18 those parties. The conflict with the Sherman Act is arguably not  
19 lessened by the fact that the private parties pay the state a  
20 share of their monopoly revenues for that protection. A state is  
21 quite able to raise revenue by taxing private parties who compete  
22 for the favor of consumers.

23 The failure of the State to elaborate a rationale<sup>24</sup> --  
24 competitive or anti-competitive -- for the market-share

1 provisions is echoed in the district court's decision and in  
2 appellees' brief. The district court, in upholding the  
3 Contraband Statutes, stated in conclusory fashion only that "New  
4 York was not seeking to create any benefit to the cigarette  
5 manufacturing companies . . . [but] was dealing . . . in a very  
6 important local health interest." Freedom Holdings, tr. at 49.  
7 Appellees' brief also resolutely denies any anticompetitive  
8 intent or effect and emphasizes public health benefits from the  
9 MSA, but only in conclusory terms.

10 A court might infer from the MSA and accompanying statutes  
11 themselves that they are thought to serve both public health and  
12 revenue enhancing purposes of the State, although the State  
13 offers no reason why it used methods suppressing competition  
14 rather than a flat tax to achieve the same result. As discussed  
15 above, it is doubtful, although we do not decide the issue, that  
16 a State may shelter private parties from the Sherman Act solely  
17 in order to share monopoly profits. Moreover, at this stage in  
18 the proceeding and given the allegations of the complaint, the  
19 goals of serving public health and enhancing revenue conflict.  
20 That is to say, the fewer cigarettes sold, the less threat to  
21 public health, but also the less revenue raised by the State, and  
22 vice versa. Also, because the MSA requires the PMs to pay a  
23 fixed fee per cigarette but leaves them free to set whatever  
24 price they choose, the resolution of the price/sales/public

1 health conflict is left by the MSA to the PMs, whose concern for  
2 public health, or for that matter State revenues, is not self-  
3 evident.

4       So far as we can tell, the principal public discussion of  
5 the effect of the market-share provisions of the MSA on  
6 competition took place when the major tobacco companies  
7 unsuccessfully sought from the Congress an exemption from the  
8 Sherman Act for the MSA. See Tobacco Settlement: Hearing Before  
9 the Senate Comm. on Commerce, Sci. and Transp., 105th Cong.  
10 (1998) (LEXIS, National Narrowcast Network) (statement of Robert  
11 Pitofsky, Chairman, Federal Trade Commission) (The antitrust  
12 exemption "is vague, it's open ended, and in my opinion, it's  
13 largely unprecedented. We don't give industries exemptions from  
14 the antitrust laws, if we think the competitive system will work.  
15 And it seems to me it certainly can work with respect to tobacco  
16 products. [An antitrust exemption] also could produce  
17 unfortunate consequences. One of the goals of the agreement is  
18 to raise the price of a pack of cigarettes, so as to discourage  
19 young people from smoking. This provision, as it reads here,  
20 says that the tobacco executives can get together in a room and  
21 agree on what the price of a pack of cigarettes is. It could be  
22 a price much higher than the cost of the annual payments. That  
23 seems to me not sensible. Now, the companies have come forward  
24 with a number of reasons why they say they need an antitrust

1 exemption. They have to agree on what the payments are, if  
2 annual payments are required. Why do they have to agree? I  
3 mean, the payments will be required by law. All they have to do  
4 is obey the law.”).

5 As noted, an ancillary function of the first Midcal prong is  
6 to establish the legitimate State policy underlying the decision  
7 to displace the Sherman Act. Absent such a policy, the  
8 Contraband Statutes would contravene Parker's denial of state  
9 power to "give immunity [to the tobacco companies] by authorizing  
10 them to violate [the Sherman Act], or by declaring that their  
11 action is lawful." Parker, 317 U.S. at 351. Until now the State  
12 has relied in conclusory fashion on the claimed benefits to  
13 public health as a showstopper rendering further analysis or  
14 discussion irrelevant. It suffices to say here that, on the  
15 allegations of this complaint, the relationship of such benefits  
16 to the restraint on competition is not obvious<sup>25</sup> and may even be  
17 counterproductive.<sup>26</sup>

18 (ii) Active Supervision

19 We turn now to the second Midcal prong, whether the alleged  
20 anticompetitive scheme is actively supervised by New York. We  
21 conclude that it is not. Neither the New York statutes, the MSA,  
22 nor any other New York law or regulation “actively supervise[s]”  
23 the pricing decisions within the allegedly-anticompetitive market  
24 structure enforced by the Contraband Statutes. Appellees' brief

1 does not claim otherwise or even discuss the issue.

2 We are directed to no mechanism in the MSA or any of the  
3 related legislation whereby New York may "review[] the  
4 reasonableness" of the pricing decisions of tobacco  
5 manufacturers. Midcal, 445 U.S. at 105. Nor is there provision  
6 for New York to "monitor market conditions or engage in any  
7 'pointed reexamination' of the program." Id. at 106. The PMs  
8 are therefore free to charge the profit maximizing price, the  
9 classic monopoly result.

10 We therefore agree with the Third Circuit in Bedell, which  
11 noted:

12 [J]ust as the injury in Midcal was caused by private  
13 parties taking advantage of the state imposed market  
14 structure, the anticompetitive injury here resulted  
15 from the tobacco companies' conduct after  
16 implementation of the [MSA], and not from any further  
17 positive action by the States. Even though, as  
18 defendants argue, the [MSA] created the cartel, this  
19 fact makes the case analogous to Midcal, not different.

20 263 F.3d at 258, and then concluded:

21 The States . . . lack oversight or authority over the  
22 tobacco manufacturers' prices and production levels.  
23 These decisions are left entirely to the private  
24 actors. Nothing in the [MSA] or its [Escrow] Statutes  
25 gives the States authority to object if the tobacco  
26 companies raise their prices.

27 Bedell, 263 F.3d at 264.<sup>27</sup>

28 Therefore, under the present allegations, New York has  
29 failed to provide for any state supervision, much less active

1 supervision, of the pricing conduct of cigarette manufacturers  
2 under the anticompetitive market structure created by the MSA and  
3 the Contraband Statutes. "Absent such a program of supervision,  
4 there is no realistic assurance that a private party's  
5 anticompetitive conduct promotes state policy, rather than merely  
6 the party's individual interests." Patrick v. Burget, 486 U.S.  
7 94, 101 (1988). That leads us to conclude that the Contraband  
8 Statutes, were the allegations of the complaint proven, would not  
9 be saved by the Parker state action immunity.

10 As the Supreme Court stated in 324 Liquor, the essence of  
11 the allegation is that "[t]he State has displaced competition . .  
12 . without substituting an adequate system of regulation. 'The  
13 national policy in favor of competition cannot be thwarted by  
14 casting such a gauzy cloak of state involvement over what is  
15 essentially a private price-fixing arrangement.'" 479 U.S. at  
16 345 (quoting Midcal, 445 U.S. at 106).

#### 17 4. The Noerr-Pennington Immunity

18 Finally, appellees claim that the Contraband Statutes are  
19 protected under the Noerr-Pennington immunity. See E. R.R.  
20 Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. 127  
21 (1961); United Mine Workers of Am. v. Pennington, 381 U.S. 657  
22 (1965). The Noerr-Pennington immunity is a First Amendment-based  
23 doctrine that protects private parties from liability under the  
24 Sherman Act in connection with efforts to petition for

1 anticompetitive legislation. See Bedell, 263 F.3d at 250-51  
2 (describing Noerr-Pennington as offering private parties immunity  
3 from antitrust liability arising from the act of petitioning or  
4 from government action which results from the petitioning).  
5 However, the immunity for advocacy cannot sensibly protect the  
6 resultant anticompetitive legislation from being held to be  
7 preempted as in conflict with the Sherman Act. Otherwise, all  
8 such legislation would be immune. See 1 Areeda & Hovenkamp,  
9 supra, ¶ 217a, at 301 ("[W]hen state law merely purports to  
10 authorize, or even compel, unsupervised private action of a kind  
11 that violates the antitrust laws, the state law is preempted by  
12 the force of federal law."). Here, appellants do not seek to  
13 impose liability on private defendants but rather seek to have  
14 the Contraband Statutes declared invalid and their enforcement  
15 enjoined.

16       Given Noerr-Pennington's First Amendment concerns, and for  
17 obvious pragmatic reasons, the proper time at which to decide a  
18 preemption issue like the present one is not the pre-legislation  
19 advocacy stage. The end product of regulatory legislation can  
20 take many forms, some preempted, some not. Due to the  
21 indeterminate nature of the legislative process and the  
22 ambiguities inherent in political advocacy, a process that sought  
23 to prevent advocacy of laws that might be subject to preemption  
24 would inevitably tread on advocacy of laws that are not. This

1 does not, however, protect the ultimate legislative result from  
2 Supremacy Clause analysis. The Noerr-Pennington immunity,  
3 therefore, does not bar appellants' claims.

4 c) Equal Protection Claim

5 Appellants' selective enforcement claim is set out in part  
6 as follows:

7 The defendants subject the sales of all cigarettes by  
8 importers or wholesalers to retailers within the State  
9 of New York to the terms of the [Contraband Statutes],  
10 with the exception of sales by [wholesalers and  
11 importers]<sup>28</sup> located on Native American Reservations  
12 situated within the State of New York.

13 Compl. ¶ 3, at 3. (emphasis added). Moreover, the complaint  
14 further alleges that defendants have "selectively enforce[d]" the  
15 Contraband Statutes so as to "economically favor [wholesalers and  
16 importers] on Native American Reservations situated in the State  
17 of New York," thereby "discriminating against plaintiffs and the  
18 other members of the class" in violation of the Equal Protection  
19 Clause. Compl. ¶¶ 44, 49, at 19, 20. Finally the complaint also  
20 presents the following question as a "question of law and fact"  
21 raised by its allegations:

22 Does the defendants' consistent selective enforcement  
23 of the New York Contraband Statute in favor of direct  
24 buying [wholesalers and importers] on Native American  
25 Reservations situated within the State of New York,  
26 whereby the cigarettes those [wholesalers and  
27 importers] sell to any purchasers, including citizens  
28 and residents of the State of New York, [sic]  
29 constitute economic favoritism in favor of those Native  
30 American Reservation [wholesalers and importers] and

1 discrimination against importers such as plaintiffs and  
2 the other members of the class in violation of . . .  
3 the Equal Protection Clause . . . ?

4 Compl. ¶ 37(d), at 18.

5 To establish a violation of the Equal Protection Clause  
6 based on selective enforcement, a plaintiff must ordinarily show  
7 the following:

8 (1) [that] the person, compared with others similarly  
9 situated, was selectively treated; and (2) that such  
10 selective treatment was based on impermissible  
11 considerations such as race, religion, intent to  
12 inhibit or punish the exercise of constitutional  
13 rights, or malicious or bad faith intent to injure a  
14 person.

15 Lisa's Party City, Inc. v. Town of Henrietta, 185 F.3d 12, 16 (2d  
16 Cir. 1999) (internal quotation marks and citations omitted). The  
17 district court essentially held that appellants could not  
18 establish the second element, an impermissible consideration. In  
19 that regard, it relied on Washington v. Yakima Indian Nation, 439  
20 U.S. at 500-01 (finding that a legislative classification  
21 singling out tribal Indians was not "suspect," because of "the  
22 unique legal status of Indian tribes under federal law," and  
23 therefore employing rational basis review), and New York Ass'n of  
24 Convenience Stores v. Urbach, 92 N.Y.2d at 212-13 (applying  
25 rational basis review to a New York State policy of not enforcing  
26 tax laws with respect to on-reservation cigarette sales). See  
27 Freedom Holdings, tr. at 51.

1           We have concluded that we should remand this claim for two  
2 reasons. First, the basis for the district court's reliance upon  
3 Yakima Nation and Urbach is unclear. These decisions deal with  
4 the exercise and non-exercise respectively of state jurisdiction  
5 on reservation land. In their brief and reply brief, appellants  
6 have made it clear that the alleged discriminatory failure of  
7 enforcement occurs only with respect to "shipments made from . .  
8 . Reservations to New York wholesalers located outside of the  
9 Reservation." Appellants' Br. at 53; see also Appellants' Reply  
10 Br. at 24 ("Native American manufacturers, importers and  
11 wholesalers are free to make and sell cigarettes made by [NPMs]  
12 and ship them outside of the Reservation without being subjected  
13 to the forfeiture penalties of the Contraband Statute."). We do  
14 not therefore have the views of the district court on appellants'  
15 claim as presently framed. Because we are remanding for a second  
16 reason, we see no purpose in addressing this particular issue  
17 further on this appeal.

18           Second, under the rules of notice pleading, the complaint  
19 must contain allegations sufficient to alert the defendants to  
20 the nature of the claim and to allow them to defend against it.  
21 See Conley v. Gibson, 355 U.S. 41, 47 (1957) ("[T]he Rules  
22 require [] 'a short and plain statement of the claim' that will  
23 give the defendant fair notice of what the plaintiff's claim is  
24 and the grounds upon which it rests." (quoting Fed. R. Civ. P.

1 8(a)(2) (quoted in Swierkiewicz v. Sorema N.A., 534 U.S. 506, 512  
2 (2002))). The present complaint fails to meet this test.

3 In particular the complaint fails to explain how, and at  
4 what stage of, the resale to "wholesalers located outside of the  
5 Reservation," Appellants. Br. at 53, the non-enforcement occurs.  
6 It is alleged that any off-reservation wholesaler or importer who  
7 purchases cigarettes is subject to enforcement of the Contraband  
8 Statutes. Because subsequent sales by wholesalers and importers  
9 of cigarettes purchased from wholesalers and importers on Native  
10 American reservations are subject to the Contraband Statutes,  
11 these cigarettes would presumably bear the same tax and Escrow  
12 Statute certification burden borne by the cigarettes imported by  
13 appellants. Under the Contraband Statutes, such a wholesaler or  
14 importer would not be permitted to affix tax stamps without a  
15 manufacturer's certification of compliance with the Escrow  
16 Statute.<sup>29</sup>

17 In short, appellants fail to allege why the enforcement of  
18 the Contraband Statutes against off-reservation wholesalers and  
19 importers would not protect appellants from the competitive  
20 disadvantage of which they complain. Appellants make no  
21 allegations of any particular instances of enforcement or non-  
22 enforcement of the Contraband Statutes; they do not allege the  
23 means of non-enforcement, e.g., allowing sales without tax  
24 stamps, affixing tax stamps without certification, etc. At the

1 same time, appellants have failed to identify any of the  
2 "[wholesalers and importers] located on Native American  
3 Reservations situated within the State of New York" whom they  
4 allege to have been favored by appellees, and they have not  
5 alleged that such wholesalers and importers are tobacco product  
6 manufacturers, cigarette tax stamp agents, or firms otherwise  
7 subject to the Contraband Statutes.

8 Appellees have therefore not been provided enough  
9 information to identify the basis for, or to defend against,  
10 appellants' claim. Under the circumstances, where the particular  
11 deficiencies that concern us were neither relied upon by the  
12 district court nor argued by appellees, appellants should be  
13 allowed a further opportunity to amend their complaint. See  
14 Foman v. Davis, 371 U.S. 178, 181-82 (1962) ("It is too late in  
15 the day and entirely contrary to the spirit of the Federal Rules  
16 of Civil Procedure for decisions on the merits to be avoided on  
17 the basis of [] mere technicalities. 'The Federal Rules reject  
18 the approach that pleading is a game of skill in which one  
19 misstep by counsel may be decisive to the outcome and accept the  
20 principle that the purpose of pleading is to facilitate a proper  
21 decision on the merits.'" (quoting Conley v. Gibson, 355 U.S. at  
22 48)).

23 We therefore remand the selective enforcement claim.

24 CONCLUSION

1           For the foregoing reasons, we affirm the dismissal of the  
2 Commerce Clause claim, reverse with respect to the Sherman Act  
3 claim, and remand the Equal Protection claim for further  
4 proceedings.

5

1 FOOTNOTES

2

1. It is unclear whether this market share is of sales nationwide or just in New York.

2. Receipt of settlement payments is allocated among the Settling States pursuant to a protocol set forth in Exhibit U to the MSA.

3. The nationwide base payments begin at \$4.5 billion for the year 2000 and gradually increase to \$9 billion in the year 2018 and each year thereafter.

4. If the OPM's market share loss exceeds 16<sup>2</sup>/<sub>3</sub>%, the decrease in payment obligations is somewhat less than the treble reduction for losses between 2% and 16<sup>2</sup>/<sub>3</sub>%. See MSA at 50.

5. New York's Escrow Statute provides in part as follows:

Any tobacco product manufacturer selling cigarettes to consumers within the state (whether directly or through a distributor, retailer or similar intermediary or intermediaries) after the effective date of this article shall do one of the following:

1. become a participating manufacturer (as that term is defined in section II(jj) of the master settlement agreement) and generally perform its financial obligations under the master settlement

- agreement; or
2. (a) place into a qualified escrow fund by April  
fifteenth of the year following the year in  
question the following amounts (as such  
amounts are adjusted for inflation):
- (i) 1999: \$ .0094241 per unit sold after the  
effective date of this section;
  - (ii) 2000: \$ .0104712 per unit sold;
  - (iii) for each of 2001 and 2002: \$ .0136125  
per unit sold;
  - (iv) for each of 2003 through 2006: \$  
.0167539 per unit sold;
  - (v) for each of 2007 and each year  
thereafter: \$ .0188482 per unit sold.
- (b) a tobacco product manufacturer that places funds  
into escrow pursuant to paragraph (a) shall  
receive the interest or other appreciation on such  
funds as earned. Such funds themselves shall be  
released from escrow only under the following  
circumstances:
- (i) to pay a judgment or settlement on any  
released claim brought against such  
tobacco product manufacturer by the  
state or any releasing party located or  
residing in the state. Funds shall be  
released from escrow under this  
subparagraph: (A) in the order in which  
they were placed into escrow and (B)  
only to the extent and at the time  
necessary to make payments required  
under such judgment or settlement;
  - (ii) to the extent that a tobacco product  
manufacturer establishes that the amount  
it was required to place into escrow in  
a particular year was greater than the  
state's allocable share of the total  
payments that such manufacturer would  
have been required to make in that year  
under the master settlement agreement  
(as determined pursuant to section  
IX(i)(2) of the master settlement  
agreement, and before any of the  
adjustments or offsets described in  
section IX(i)(3) of that agreement other  
than the inflation adjustment) had it  
been a participating manufacturer, the  
excess shall be released from escrow and

- revert back to such tobacco product manufacturer; or
- (iii) to the extent not released from escrow under subparagraph (i) or (ii) of this paragraph, funds shall be released from escrow and revert back to such tobacco product manufacturer twenty-five years after the date on which they were placed into escrow.

N.Y. Pub. Health Law § 1399-pp (2002).

6. For purposes of this opinion, we use the terms "wholesalers" and "tax stamp agents" interchangeably.

7. Section 480-b provides in its entirety as follows:

§ 480-b. Prohibition against the stamping of certain cigarettes

1. Every tobacco product manufacturer as defined by section thirteen hundred ninety-nine-oo of the public health law whose cigarettes are sold for consumption in this state shall annually certify under penalty of perjury that, as of the date of such certification, such tobacco product manufacturer: (a) is a participating manufacturer as defined in subdivision one of section thirteen hundred ninety-nine-pp of the public health law; or (b) is in full compliance with subdivision two of section thirteen hundred ninety-nine-pp of the public health law. Such certification shall be executed and delivered to the commissioner, the attorney general and any agent who affixes New York state cigarette tax stamps to cigarettes of such tobacco product manufacturer, no earlier than the sixteenth day of April and no later than the thirtieth day of April of each year, and shall be accompanied by a list setting forth each of the cigarette brands of such tobacco product manufacturer sold for consumption in New York state. Agents shall retain such certifications for

a period of five years.

2. An agent may not affix, or cause to be affixed, a New York state cigarette tax stamp to a package of cigarettes if either: (a) the tobacco product manufacturer of such cigarettes has not provided such agent with the certification required by subdivision one of this section; or (b) the commissioner has notified such agent that such tobacco product manufacturer is in violation of section thirteen hundred ninety-nine-pp of the public health law, or has filed a false certification under subdivision one of this section, and such agent has not been notified by the commissioner that such violation has ceased.
3. The commissioner shall prescribe the form of the certification required to be filed pursuant to subdivision one of this section.

N.Y. Tax Law § 480-b (2002).

8. Section 1846 provides, in pertinent part, as follows:

§ 1846. Seizure and forfeiture of cigarettes

- (a) Whenever a police officer designated in section 1.20 of the criminal procedure law or a peace officer designated in subdivision four of section 2.10 of such law, acting pursuant to his or her special duties, shall discover any cigarettes subject to tax provided by article twenty of this chapter or by chapter thirteen of title eleven of the administrative code of the city of New York, and upon which the tax has not been paid or the stamps not affixed as required by such article or such chapter thirteen, they are hereby authorized and empowered forthwith to seize and take possession of such cigarettes, together with any vending machine or receptacle in which they are held for sale. Such cigarettes, vending machine or receptacle seized by a police officer or such peace officer shall be turned over to the commissioner. Such seized cigarettes, vending machine or receptacle, not including money contained in such vending machine or receptacle, shall be forfeited to the state. . . .

- (a-1) Whenever a police officer designated in section 1.20 of the criminal procedure law or a peace officer designated in subdivision four of section 2.10 of such law, acting pursuant to his or her special duties, shall discover any cigarettes which have been stamped in violation of section four hundred eighty-b of this chapter, such officer is hereby authorized and empowered forthwith to seize and take possession of such cigarettes, and such cigarettes shall be subject to a forfeiture action pursuant to the procedures provided for in article thirteen-A of the civil practice law and rules, as if such article specifically provided for forfeiture of cigarettes seized pursuant to this section as a preconviction forfeiture crime. Subdivisions (b), (c) and (d) of this section shall not apply to cigarettes seized pursuant to this subdivision.

N.Y. Tax Law § 1846 (2002).

9. Section 481, subdiv. 1(c) provides as follows:

In addition to any other penalties that may be imposed by law, the commissioner may impose a civil penalty not to exceed five thousand dollars against any tobacco product manufacturer or cigarette tax agent who violates the provisions of section four hundred eighty-b of this article, including but not limited to the filing of a false certification, and may seek to suspend or cancel any license which has been issued to such person pursuant to this chapter.

N.Y. Tax Law § 481, subdiv. 1(c) (2002).

10. The complaint does not specify whether appellants are themselves licensed New York State tax stamp agents. Because appellants are bringing suit only on behalf of that class of firms who resell cigarettes to "[wholesalers] having New York cigarette tax stamp licenses," Compl. ¶ 1, at 2, we consider

appellants solely as "importers" and not as "wholesalers," or licensed New York State tax stamp agents.

11. While an allegation of such a wholly "extraterritorial" effect has been analyzed by the Second Circuit as a form of "disproportionate[] burden" on interstate commerce under the Pike balancing test, see Nat'l Elec. Mfrs., 272 F.3d at 109-10 (treating "control of commerce that occurs wholly beyond the state's borders" as a "disparate" burden triggering Pike balancing analysis), it may also be analyzed independently -- i.e., without reference to clear discrimination or disparate burdens -- as a question of regulatory jurisdiction rather than one of regulatory discrimination. See Healy, 491 U.S. at 336 (considering a dormant Commerce Clause challenge to the extraterritorial effect of a state statute without reference to Pike); Edgar v. MITE Corp., 457 U.S. 624, 643 (1982) (plurality opinion) ("The limits on a State's power to enact substantive legislation are similar to the limits on the jurisdiction of state courts. In either case, 'any attempt "directly" to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power.'" (quoting Shaffer v. Heitner, 433 U.S. 186, 197 (1977))); Automated Salvage Transp., 155 F.3d at 77-78 (noting that "[t]he Commerce Clause 'precludes the application of a state

statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State.'" (quoting Edgar v. MITE Corp., 457 U.S. at 642-43 (plurality opinion)) (emphasis added)); see also Pharm. Research & Mfrs. of Am. v. Concannon, 249 F.3d 66, 79 (1st Cir. 2001), aff'd, 123 S. Ct. 1855, 1870-71 (2003) (considering extraterritorial effect as an independent, per se ground for a statute's invalidation under the dormant Commerce Clause); Cotto Waxo Co. v. Williams, 46 F.3d 790, 793 (8th Cir. 1995) (same).

12. Appellants' complaint arguably asserts only the first, "clear discrimination" form of dormant Commerce Clause violation, see Compl. ¶ 42, at 18-19 ("[The Contraband Statutes] constitute[] a direct interference with interstate commerce. . . . Such favoritism, discrimination and economic protectionism per se violates the Commerce Clause."). The district court held the Contraband Statutes not to be discriminatory and went on to hold that even under the second, "Pike balancing test" analysis any burden incidentally imposed by the Contraband Statutes was outweighed by the local benefits secured. Appellants' brief on appeal reiterates the claim of a "clear discrimination" form of Commerce Clause violation, see, e.g., Appellants' Br. at 19 ("The Contraband Statute constitutes a virtually per se violation of the dormant Commerce Clause."); id. at 23 ("[T]he protectionist

objective is facially apparent"), but does not propose that we engage in a Pike "incidental burdens" analysis. In their reply brief, appellants advance for the first time a claim of the third, "extraterritorial" form of Commerce Clause violation described above. See Appellants' Reply Br. at 7 (citing Healy, 491 U.S. 324).

13. In this context, little danger of "inconsistent legislation" exists. In fact, a universal and practically uniform national system of payments by tobacco companies to states has been created. As noted, all of the Settling States have enacted the form Escrow Statute, see Compl. ¶ 19, at 10, and 24 have passed Contraband Statutes, see Appellants' Rule 28(j) letter.

Furthermore, each of the four states that did not join the MSA -- Florida, Minnesota, Mississippi and Texas -- settled individually with the major tobacco companies. See State v. Philip Morris, 179 Misc. 2d at 439-40 n.3. These individual settlements were similar to the MSA; for example, in approving New York's participation in the MSA, the New York County Supreme Court stated that "[t]he MSA for New York contains every single public health provision found in the Minnesota settlement." Id. at 444.

14. In Seelig, the Supreme Court struck down a New York statute that (a) established in-state minimum wholesale milk prices, and

(b) banned the resale in New York of milk purchased out-of-state at wholesale prices below in-state minimums. Seelig, 294 U.S. at 519. The Court found that the statute's effect was to set minimum out-of-state wholesale milk prices, stating:

It is one thing for a state to exact adherence by an importer to fitting standards of sanitation before the products of the farm or factory may be sold in its markets. It is a very different thing to establish a wage scale or a scale of prices for use in other states, and to bar the sale of the products, whether in the original packages or in others, unless the scale has been observed.

Id. at 528.

15. In Brown-Forman, the Supreme Court struck down a New York statute that required liquor distillers to certify that their in-state prices were no higher than the lowest price at which the same product would be sold out-of-state during the month. Brown-Forman, 476 U.S. at 575-76. The Court noted that, under the statute, "[o]nce a distiller has posted prices in New York, it is not free to change its prices elsewhere in the United States during the relevant month. Forcing a merchant to seek regulatory approval in one State before undertaking a transaction in another directly regulates interstate commerce." Id. at 582 (footnote omitted).

16. In Healy, the Supreme Court struck down a Connecticut statute

that required out-of-state beer importers to certify that the prices at which the products were sold to Connecticut wholesalers were no higher than prices at which those same products were sold in bordering states. Healy, 491 U.S. at 326. The Court held the statute to be unconstitutional because it had the effect of controlling prices in neighboring states, thereby interfering with those states' regulatory schemes and because it discriminated against those brewers and shippers of beer who were engaged in interstate commerce. Id. at 337-40.

17. Appellees rely upon our decision in Battipaglia v. New York State Liquor Authority, 745 F.2d 166 (2d Cir. 1984), which stated that in that case "plaintiffs have been faced from the outset with the difficulty that the challenged provisions of the [state statute] do not compel any agreement," id. at 170, to support their argument that a private "contract, combination, or conspiracy" must be shown for Sherman Act preemption to occur. However, Battipaglia actually noted diverging lines of authority on the question of whether a showing of a private agreement is necessary for preemption, and ultimately declined to "resolve that difficult question." Id. at 173. The majority did not reach the question because it held that the anticompetitive acts at issue in that case -- the exchange of price information -- would constitute only a rule-of-reason restraint rather than a

per se restraint. Id. at 174-75 (citing Rice v. Norman Williams Co., 458 U.S. 654, 659-62 (1982)). In any event, since our decision in Battipaglia, the Supreme Court has made it clear that an actual "contract, combination or conspiracy" need not be shown for a state statute to be preempted by the Sherman Act. 324 Liquor, 479 U.S. at 345-46 n.8.

18. Appellees claim that appellants, while challenging the Contraband Statutes, have conceded the validity of the MSA and the Escrow Statute under the Sherman Act. See Appellees' Br. at 38. No such concession has been made. Indeed, it is clearly alleged that the Contraband Statutes are anticompetitive precisely because they implement the cartel established by the MSA. Appellants do not challenge the MSA directly because it is the Contraband Statutes, not the MSA standing alone, that injures them.

19. The proposed exemption, part of a bill sponsored by Senator McCain and introduced on November 7, 1997, read as follows:  
"Antitrust Exemptions.-The provisions of the Sherman Act (15 U.S.C. 1 et seq.), the Clayton Act (29 U.S.C. 52 et seq.), and any other federal or state antitrust laws shall not apply to an association or organization to which subsection (B) applies."  
Universal Tobacco Settlement Act, S. 1415, 105th Cong. § 155(D)

(1997). Subsection (B) applied to tobacco industry trade organizations or other associations that met certain requirements for "independent" boards and bylaws. Id. at § 155(B). According to testimony at a Senate hearing, a broader antitrust immunity provision was also considered, which read as follows: "In order to achieve the goals of this agreement and the Act relating to tobacco use by children and adolescents, the tobacco product manufacturers may, notwithstanding the provisions of the Sherman Act, the Clayton Act, or any other federal or state antitrust law, jointly confer, coordinate, or act in concert, for this limited purpose." Tobacco Settlement: Hearing Before the Senate Comm. on Commerce, Sci. and Transp., 105th Cong. (1998) (LEXIS, National Narrowcast Network) (statement of Robert Pitofsky, Chairman, Federal Trade Commission). This provision, however, does not appear in any version of the legislation available on lexis.com.

20. Appellees suggest in a footnote that the state action immunity turns upon whether the defendants in the action are private parties or state officials. See Appellees' Br. at 42-43 n.13. We disagree. If a state statute is preempted, state officials may be prevented from enforcing it. In fact, in 324 Liquor, the members of the New York State Liquor Authority were parties to the action and were prevented from enforcing the law

challenged there. The only distinction between 324 Liquor and the present case is that, in 324 Liquor, the state officials initiated the action. See Brief for Appellants, 324 Liquor Corp. v. Duffy, 479 U.S. 335 (1987) (No. 84-2022).

21. Appellees have not argued that because the MSA is a settlement of a lawsuit, it somehow achieves an immunity not otherwise available. Of course, such an argument would be fruitless. First, such an argument would negate appellees' claim that the requisite contract, combination or conspiracy is lacking. See "Unilateral Act of State," subsection (b)(2)(i), supra. Second, Sherman Act violations are generally not immunized because the anticompetitive scheme is embodied in the settlement of a lawsuit. See United States v. Singer Mfg. Co., 374 U.S. 174 (1963) (holding that settlement agreements between the Singer Company and its Italian and Swiss competitors violated the Sherman Act); Duplan Corp. v. Deering Milliken, Inc., 594 F.2d 979, 981 (4th Cir. 1979) (per curiam) (affirming district court's finding that settlement agreement "was the core of a scheme to stabilize and maintain production royalties . . . and to monopolize the United States market."). Third, this result is not altered because a state attorney general has negotiated such an agreement. If the law were otherwise, a state attorney general would be able to do what Midcal and 324 Liquor deny state

legislatures by bringing a lawsuit and settling in an anticompetitive agreement. If the model of the MSA was followed, the state attorneys general might collectively establish a nationwide cartel. See note 13, supra.

22. Section 1399-nn states:

Findings and purpose

1. Cigarette smoking presents serious public health concerns to the state and to the citizens of the state. The Surgeon General has determined that smoking causes lung cancer, heart disease and other serious diseases, and that there are hundreds of thousands of tobacco-related deaths in the United States each year. These diseases most often do not appear until many years after the person in question begins smoking.

2. Cigarette smoking also presents serious financial concerns for the state. Under certain health-care programs, the state may have a legal obligation to provide medical assistance to eligible persons for health conditions associated with cigarette smoking, and those persons may have a legal entitlement to receive such medical assistance.

3. Under these programs, the state pays millions of dollars each year to provide medical assistance for these persons for health conditions associated with cigarette smoking.

4. It is the policy of the state that financial burdens imposed on the state by cigarette smoking be borne by tobacco product manufacturers rather than by the state to the extent that such manufacturers either determine to enter into a settlement with the state or are found culpable by the courts.

5. On November twenty-third, nineteen hundred ninety-eight, leading United States tobacco product manufacturers entered into a settlement agreement, entitled the "Master Settlement Agreement," with the state. The master settlement agreement obligates these manufacturers, in return for a release of past, present and certain future claims against them as described therein, to pay substantial sums to the state

(tied in part to their volume of sales); to fund a national foundation devoted to the interests of public health; and to make substantial changes in their advertising and marketing practices and corporate culture, with the intention of reducing underage smoking.

6. It would be contrary to the policy of the state if tobacco product manufacturers who determine not to enter into such a settlement could use a resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the state will have an eventual source of recovery from them if they are proven to have acted culpably. It is thus in the interest of the state to require that such manufacturers establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise.

N.Y. Pub. Health Law § 1399-nn (2002).

23. See Antitrust Implications of the Global Tobacco Settlement: Hearing Before the Senate Comm. on the Judiciary, 105th Cong.

(1997) (LEXIS, National Narrowcast Network) (statement of Robert Pitofsky, Chairman, Federal Trade Commission) ("The arguments that I've heard as to why this kind of exemption is necessary are as follows: One, that it's important to ensure that the annual payments, that could amount to \$15 billion a year in five or six years, be passed along in the form of higher prices. But one has to ask the question: Why do you need an antitrust exemption to do that? If the excise taxes go up or have gone up in the past, there are studies that show they've been passed along to consumers. If the price of paper or tobacco went up in an industry like this, wouldn't we expect that the increased costs

would be passed along to consumers? An exception of this kind would be most unusual, it could be construed to allow a kind of price fixing that I think we would not be comfortable with, and therefore I just can't see a justification along that line.").

24. We of course do not foreclose the State from offering a rationale for the market-share scheme in subsequent proceedings.

25. The principal health benefit from the arrangement as alleged appears to be that cigarette sales will be reduced by the higher prices that result from the cartel arrangement. However, because cigarettes are addictive, the demand for them is relatively inelastic, at least in the short run, and the health benefits from this aspect of the MSA have a ceiling. Moreover, given the broad police powers of the state to regulate the marketing of dangerous commodities, effective public health measures other than affording tobacco manufacturers a cartel are ubiquitous and far more obvious than the complex market-share arrangements of the MSA enforced by the Contraband Statutes. For example, if limiting sales of cigarettes by higher prices is chosen as a public health measure, a flat but high tax on each cigarette sold would alone do the trick. Similarly, restrictions on marketing could be enacted.

26. Some of the Settling States may come to rely heavily on revenue from the MSA, as perhaps reflected in Governor Pataki's statement. See also Rick Hampson, States Squander Chance to Help Fight Smoking, USA Today, Mar. 11, 2003, at B1 (quoting Washington state attorney general's statement that "[t]he money in the tobacco settlement is as addictive to states as the nicotine in cigarettes is to smokers"); Gordon Fairclough and Vanessa O'Connell, Co-Dependents: Once Tobacco Foes, States are Hooked on Settlement Cash, Wall St. J., Apr. 2, 2003, at A1 (quoting R.J. Reynolds executive's statement that after the settlement, "the states make more money from each pack of cigarettes sold than anyone else"). Some Settling States may therefore have second thoughts about measures to reduce further the sale of cigarettes. In that regard, some Settling States have issued bonds that are secured by future tobacco revenue under the MSA but would become obligations of the particular States should tobacco revenues be insufficient. See Deborah Finestone, Oregon Sells \$428 Million Backed by Dual Security Pledge, Bond Buyer, April 7, 2003, at 5; Christine Albano, The Week Ahead: New York's \$2.3B Tobacco Sale Seeks to Sublimate the Stain, Bond Buyer, June 9, 2003, at 40. Further reductions in the sale of cigarettes might have very severe fiscal consequences for such States.

There are also increasing signs of alliances between the

Settling States and the OPMs. For example, 37 state and territorial attorneys general appeared as amici on behalf of a cigarette manufacturer's motion in an Illinois state court to reduce an appellate bond that might throw the company into bankruptcy. Brief of Amici Curiae Attorneys General, Price v. Philip Morris, Inc., No. 00-L-112 (3d Cir. Ill. Apr. 2003) (unpublished decision); William McQuillen, "Progress" in Philip Morris Lawsuit: US \$12 Billion in Dispute, National Post (Bloomberg), April 12, 2003, at FP7. Finally, in the wake of that incident and at the request of their attorneys general, 16 states have passed legislation capping the size of appeal bonds that can be required of corporations. See, e.g., Va. Code Ann. § 8.01-676.1(J) (2003) (effective March 10, 2000) ("If the appellee in a civil action obtains a judgment for damages other than compensatory damages, or in excess of the compensatory damages, and the appellant seeks a stay of execution of the judgment in order to obtain review in the Court of Appeals or Supreme Court, the appeal bond or irrevocable letter of credit for the portion of the damages, other than the compensatory damages, or in excess of the compensatory damages, shall not exceed \$ 25,000,000.") The bond-capping legislation in four of the Settling States is limited to corporations that are MSA PMs. See, e.g., Nev. Rev. Stat. Ann. § 20.035(1) (2003) (effective May 29, 2001) ("[I]f an appeal is taken of a judgment in a civil action in which [a PM]

is required to give a bond in order to secure a stay of execution of the judgment during the pendency of the appeal, the amount of the bond must not exceed \$ 50,000,000."). See also Fairclough and O'Connell, supra.

27. In a replay of their argument rejected in subsection (b)(2)(i) of this section of the opinion, namely that Parker requires a private "contract, combination, or conspiracy" to satisfy the per se violation requirement and that unilateral acts of a state are immune, appellees argue that the active supervision requirement should not be applied in this case:

Where challenged acts are those of private parties, as were the acts in Bedell, [the Midcal active supervision requirement will apply]. In contrast, acts of a State's legislature -- like those that Plaintiffs have challenged here -- are always immune under the state action doctrine. Hoover v. Ronwin, 466 U.S. 558 (1984)  
. . . .

Appellees' Br. at 42 n.13. This argument is clearly contrary to the decisions in Midcal, 445 U.S. at 105, and 324 Liquor, 479 U.S. at 341-45.

Appellees' reliance upon Hoover v. Ronwin, 466 U.S. 558 (1984), is misplaced. That case held an allegedly anticompetitive Arizona bar admission program immune from antitrust challenge where, although the program was largely administered by a committee of private law practitioners, the practitioners were conceded to be "state officers" in carrying

out their committee functions, and the Arizona Supreme Court nevertheless “retained strict supervisory powers and ultimate full authority” over the committee’s actions. Id. at 572. The Court did state in that case that legislative state action is “ipso facto” immune under federal antitrust law, id. at 568, but that decision was in the context of anticompetitive conduct performed entirely by state actors, without any private involvement, and therefore effectively satisfied the Midcal supervision requirement. See 1 Areeda & Hovenkamp, supra ¶ 227, at 492.

28. Before the district court, appellants indicated that the term “retailers” should be replaced by “wholesalers and importers” for purposes of their Equal Protection claim. See Freedom Holdings, tr. at 51. We have therefore deemed the appellants’ complaint to be altered where such alternation is appropriate.

29. Appellants have not alleged otherwise. In their reply brief appellants conclusorily state that wholesalers “know” that cigarettes sold to them from reservations “have not been and will not be seized” under the Contraband Statutes. See Appellants’ Reply Br. at 26 (emphasis added). However, appellants have made no allegations, in their complaint, in the proceedings below, or in their briefs, that, under appellees’ enforcement program,

cigarettes sold into New York from reservations have continued to be exempted from Contraband Statute enforcement from wholesaler to consumer. Appellants have alleged only that the Contraband Statutes are not enforced with respect to the initial sale -- from the reservation to the wholesaler. See Compl. ¶ 3, at 3; Freedom Holdings, tr. at 51; Appellants' Br. at 53; Appellants' Reply Br. at 25.